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Theory & Practice: SEC Issues Guidelines for Management’s Discussion and Analysis of Financial Condition and Results of Operations

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The Woman CPA is pleased to introduce **Florence Haggis, CPA, MBA,** *as editor of the Theory & Practice column. She is audit manager with Touche Ross & Co. at their executive offices in New York and has had academic staff experience at Upsala College. Ms. Haggis is past national president of AWSCPA, past president and founder of North Jersey Chapter of ASWA, is a member of AICPA and Chairman of the Practice Review Committee of the New Jersey Society of Certified Public Accountants. She has been a contributor to the CPA Journal, wrote a chapter for the Touche Ross & Co.* Accountants Handbook *and revised the* Accountants SEC Practice Manual *(CCH).*

Theory & Practice

SEC Issues Guidelines for Management's Discussion and Analysis of Financial Condition and Results of Operations

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In 1980 the SEC adopted a sweeping revision of the mandatory business and financial disclosure requirements applicable to most U.S. publicly-held companies. This major revision, commonly known as the Integrated Disclosure System, standardized requirements for the form, content and timing of financial statements required by the 1933 and 1934 Securities Acts. One of its major changes was in the requirements of Regulation S-K, Item 11, for management's discussion and analysis of financial condition and results of operations. The new revised rules required information on financial condition as well as results of operations, and emphasized liquidity, capital resources, and the impact of inflation. In addition, the SEC encouraged but did not mandate forward-looking information. The overall rules were intentionally left general, with a minimum of specific requirements; companies were encouraged to disclose matters that were most significant in their particular circumstances.

A management's discussion and analysis of operations (MD&A) was first required in 1974. The rules stated then that annual reports to shareholders must include a "management's discussion and analysis of operations" for the latest two years, with detailed discussion of all material period-to-period changes in items of revenue and expense. The rules provided some very specific percentage tests with regard to these disclosure requirements, and as a result, MD&A reporting developed into a highly mechanistic and uninformative commentary on percentage variations.

It also became obvious that the focus of operations alone did not fulfill the SEC's original objective which was to provide needed information on an enterprises's planned future operations. Therefore, when the SEC revised its reporting requirements in 1980, it drew up a completely new set of MD&A rules.

Now, over one year later, SEC has issued its assessment of the Management's Discussion and Analysis sections of the 1980 annual reports (published in Accounting Series Release No. 299).

What was their evaluation of the 1980 MD&A sections? The SEC noted major improvements in the quality of MD&As although they "varied considerably in content, format and extent of coverage." More information has been presented on segments, significant events and trends, financial condition and changes in financial condition. The new discussions of economic, industry and specific factors, and uncertainties give a clearer picture of the company's financial position. Furthermore, many registrants disclosed forward-looking information about expenditures, operations and liquidity.

ASR 299 also provides examples of disclosures made by registrants under the new requirements which could be very helpful. In addition, the ASR provides guidance where further improvements could be made.

Following are some of the highlights of the SEC's observations:

Results of Operations

Although issuers have improved the form and content of their discussions of results of operations in terms of trends and segment disclosures, there is still a need to identify and discuss significant company events, including external as well as internal happenings (for example, the effect of the decontrol of U.S. oil prices, or the proposed Canadian oil production taxes and price restrictions).

Liquidity and Capitol Resources

Item 11 defines liquidity as "the ability of an enterprise to generate adequate amounts of cash to meet the enterprises's needs for cash." It has both short-term and long-term aspects involving internal as well as external sources and is often closely associated with an enterprises's capital resources. ASR 299 emphasizes that

- liquidity information should help users in evaluating a company's ability to generate sufficient cash to meet both current and projected cash needs;
- existing sources of liquidity include cash balances, assets readily convertible to cash, and current operating cash flows.
- MD&A should address liquidity in the broadest sense — that is, it should describe how operating cash flows may be impacted by internal and external sources, future commitments, trends in liquidity, significant events, uncertainties and changes in circumstances and explain that past results of operations are indicative or not indicative of the future;
- the discussion of liquidity ought to go beyond a simple review of current assets and liabilities;
- issuers should identify those balance sheet, income and cash flow items believed to be indicators of liquidity, and explain the reasons why those particular indicators are appropriate. Indicators of liquidity may be unused credit lines, debt-equity ratios, bond ratings, and restrictions under existing debt agreements;
- the liquidity discussion should compare assured available resources to expected short and long term requirements, discuss any identified deficiencies, and describe what action the issuer intends to take to meet those deficiencies.

As to remedies, ASR 299 encourages issuers to describe any anticipated cash resources, e.g., potential cash flows from expanded levels of operations, additional external financing, the sale of non-operating assets, etc. Issuers are also encouraged to identify and discuss factors relevant to an understanding of the company's future plans, objectives, and ability to complete those plans.

Evaluation of Disclosures

Short-term liquidity discussions generally have focused on working capital, "frequently supplemented only with information on funds flow from operations computed on a working capital basis." ASR 299 urges companies to make sure that the discussion fully addresses the subject of liquidity, since the ability to generate cash to meet cash needs generally depends on factors other than just working capital.

Using only working capital can significantly misrepresent a company's liquidity. It may hide both the uncertainty and timing of the conversation of current assets to cash or, conversely, it may fail to give the company credit for deliberately using cash management techniques that minimize current assets in relation to current liabilities. Furthermore, such a presentation of liquidity will probably fail to take into account the impact of unused available short-term credit; and it may only reflect LIFO inventory, thereby understating inventory values.

As an example of this kind of misrepresentation, ASR 299 points out that disclosures of a 3:1 ratio could lead to the assumption "that the company has ample ability to generate cash to meet its obligations in a timely manner. However, if the current assets consist of 10 percent cash, 50 percent receivables and 40 percent inventory, with approximately three-quarters of the inventory in raw or uncompleted form, it may be necessary to know turnover rates to evaluate the company's cash position accurately."

Another problem is that discussions of "working capital provided from operations" (as shown in most funds statements) can lead to "the erroneous concept that non-cash charges to income, such as depreciation, are sources of liquidity." To avoid this, MD&A should be expanded to include "cash flow from operations and other sources." This category should not be limited to net income adjusted for non-cash charges and credits, but should also consider changes in the various components of working capital — such as receivables, payables and inventory.

Computed this way, cash flow from operations is an especially helpful indicator, and the SEC encourages its display as a three-year trend. Note that "this measure is frequently very different from "funds flow from operations" computed on a working capital basis and the captions should not be used interchangeably."

In addition to cash flow from operations and related working capital conditions, the ASR suggests that assessments of liquidity should also include consideration of the following:

(i) Available unused sources of financing, including existing lines of credit, ease of access to markets, and convertibility of noncurrent assets to cash.
(ii) Trends in liquidity and known commitments.
(iii) Known or likely deficiencies and remedies.
(iv) Significant events and uncertainties, including flexibility to adapt to change.

The ASR gives examples of disclosures along these lines.

Inflation Disclosures

The SEC was concerned also about the adequacy of disclosures regarding the impact of inflation and changing prices on businesses. Although SFAS 33 applies only to certain companies, the SEC encouraged all issuers "to focus on translating the potentially confusing situation concerning inflation into a meaningful discussion of the effects of changing prices" on their business.

Illustrations of disclosures included the impact of inflation on:

(i) Sales
(ii) Monetary Assets/Liabilities
(iii) Inventory and Cost of Sales
(iv) Plant Assets and Depreciation, and
(v) Financial Intermediaries, such as, banks, savings and loan companies.

Conclusion

For those who are responsible for complying with the disclosure requirements of Regulation S-K, or for those of us who have SEC clients who need advice regarding Management's Discussion and Analysis, ASR 299 can be an invaluable aid, because it contains numerous illustrations and suggestions.

The ASR and its examples should be read carefully as useful reference material. However, keep in mind that the examples are only excerpts of more extensive disclosure and are not all-encompassing.

The SEC anticipates that MD&A disclosures will continue to improve with time, and the Commission intends to continue to review the MD&A disclosures and perhaps provide additional guidance in subsequent releases.

As a final note — the SEC, at the 1982 AICPA Current SEC Developments Conference in Washington, D.C., stated that MD&A will be the focal point of staff reviews of filings in the coming year. Ω